Investment Management Regulatory Update

March 29, 2016

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SEC Rules and Regulations

SEC Extends Comment Period on Proposed Rule and Concept Release on Transfer Agent Regulations

On February 18, 2016, the Securities and Exchange Commission (the "**SEC**") issued a release to extend the comment period for the advanced notice of proposed rulemaking for new requirements for transfer agents (the "**Proposed Rule**") and accompanying concept release requesting public comment on the SEC's holistic review of the regulation of transfer agents (the "**Concept Release**") from February 29, 2016 to April 14, 2016. The SEC originally issued the Proposed Rule and Concept Release on December 22, 2015. In the Concept Release, the SEC discussed the role of transfer agents to registered investment companies. For a discussion of the Proposed Rule and Concept Release, see the **January 27, 2016 Investment Management Regulatory Update**.

- **See a copy of the Release**
- **See a copy of the Proposed Rule and the Concept Release**

SEC Staff Grants No-Action Relief Allowing Use of Rule 486(b) to File Post-Effective Amendments to Closed-End Fund's Registration Statement

On February 25, 2016, the SEC Staff issued a no-action letter (the "**Letter**") giving relief to a closed-end management investment company that sought to use Rule 486(b) under the Securities Act of 1933 (the "**Securities Act**") ("**Rule 486(b)**") to file post-effective amendments to its registration statement on Form N-2 (the "**Registration Statement**"). The Letter provided substantially similar relief as a no-action letter dated January 7, 2015 issued to Fiduciary/Claymore ML Opportunity Fund. Please see the **January 27, 2016 Investment Management Regulatory Update** for further detail on that letter.

According to the incoming letter (the "**Incoming Letter**"), BlackRock Health Sciences Trust (the "**Fund**") is a closed-end management investment company registered under the Investment Company Act of 1940 (the "**Investment Company Act**"). The Incoming Letter stated that under the Fund's Registration Statement, the Fund may issue common shares of beneficial interest on a delayed and continuous basis in accordance with Rule 415(a)(1)(x) under the Securities Act ("**Rule 415**"). Form N-2, the registration statement generally used by closed-end funds, requires closed-end funds to "file, during any period in which offers or sales are being made, a post-effective amendment to the registration statement." Since the Fund has been engaged in a continuous offering of securities, it is required to file a post-effective amendment in accordance with Section 8(c) of the Securities Act ("**Section 8(c)**") on an annual basis to update its Registration Statement with audited financial statements and other non-material updates. According to the Incoming Letter, since Section 8(c) does not provide for automatic effectiveness, such post-effective amendments must go through an often lengthy process of SEC review and comment before each can be declared effective by the SEC. The Incoming Letter noted that during the period before such amendments are declared effective, the Fund is unable to issue new shares, which, the Incoming Letter argues, harms the Fund and its shareholders by potentially preventing them from taking advantage of favorable market conditions.

Pursuant to Rule 485 under the Securities Act, open-end management investment companies, unit investment trusts and face-amount certificate companies are generally allowed to file post-effective amendments with automatic or immediate effectiveness. Rule 486(b) generally allows closed-end funds that are operated as registered closed-end management investment companies or business development companies which make periodic repurchase offers under Rule 23c-3 of the Investment Company Act ("**Interval Funds**") to file post-effective amendments with immediate effectiveness on the date of filing or on a designated later date, provided that such amendments satisfy certain conditions, including non-materiality conditions. Since the Fund is neither an open-end management investment company nor an Interval Fund, according to the Incoming Letter, it is not permitted to file post-effective amendments without the delay that is imposed by Section 8(c).

The Incoming Letter noted that the SEC had previously stated, in the adopting release for Rule 486, that "[t]he initial proposal of Rule 486 recognized that closed-end interval funds may need continuously effective registration statements and would benefit if certain filings could become effective automatically". According to the Incoming Letter, such reasoning should be extended to the Fund since it is a closed-end fund that is conducting delayed or continuous offerings pursuant to Rule 415, and would benefit from having a continuously effective registration statement. In addition, the Incoming Letter claimed that the facts presented in the Incoming Letter were similar to the facts in several previous no-action letters, where the SEC issued guidance granting relief to other closed-end funds based on the representations that (i) the respective funds' boards of directors had approved the funds' delayed or continuous offerings; (ii) each fund's post-effective amendments would comply with Rule 486(b); and (iii) in accordance with Section 8(c), each fund would file a post-effective amendment containing a prospectus prior to any offering of its common stock at a price below net asset value. The Incoming Letter argued that since the Fund would comply with the requirements of Rule 486(b) and Section 8(c) in issuing its post-effective amendments, the public policy of protecting investors would be safeguarded while providing the benefits of flexibility, cost reduction and quicker access to information to the Fund, its shareholders and potential investors. The Incoming Letter also stated that in relying on the requested relief to sell common shares of beneficial interest, the Fund would sell newly issued shares at a price no lower than the sum of the Fund's net asset value plus the per share commission or underwriting discount.

According to the Letter, the SEC would not recommend enforcement action under Section 5(b) or Section 6(a) of the Securities Act against the Fund based on the facts and representations in the Incoming Letter. The Letter further noted that the Fund has acknowledged that the SEC may withdraw its relief if it finds that the Fund is misusing Rule 486(b) or for any other reason. The staff expressly stated that, in light of the "very fact-specific nature" of the Fund's request, however, the position expressed in the Letter applies only to the Fund, and no other entity may rely on this position.

- See a copy of the Letter
- See a copy of the Incoming Letter

Industry Update

SEC Division of Investment Management Issues Guidance on Disclosure by Registered Investment Companies Relating to Current Market Conditions

In March, 2016, the staff of the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update to remind mutual funds, exchange-traded funds and other registered investment companies (collectively, "**Funds**") of the importance of reviewing risk disclosures periodically to determine whether such disclosures remain sufficient in light of current market conditions.

The staff first underscored the importance of clear and fulsome disclosure to investors of the risks of investing in Funds and, therefore, the need for Funds to assess on an ongoing basis whether existing disclosure is adequate in light of changing market conditions. The staff advised that undertaking the following steps should assist Funds in providing adequate risk disclosures to investors that take into account any changing market conditions:

- **Monitor market conditions and their impact on Fund risks**. The staff highlighted the importance of continuously monitoring market conditions to evaluate their impact on the Fund and the risks associated with the Fund's investments.
- **Assess the adequacy with which Fund risks have been communicated to investors**. The staff advised that if a Fund decides that changed market conditions have affected the risks associated with the Fund or its investments and such change is material and/or significant, it should then consider whether existing disclosures are adequate.
- **Communicate with investors**. Lastly, if a Fund determines that existing disclosures are not adequately taking into account a changed market condition, the Fund should, according to the staff, update its communications to investors at the time and in the manner required by the federal securities laws and as otherwise appropriate.

The staff then described two examples of disclosures it has observed in light of changing market conditions that highlighted conditions in a manner that it believes could make disclosure "more timely, more meaningful and more complete." The first relates to disclosures by fixed income Funds in response to the Federal Reserve Board's cessation of quantitative easing in 2014, a statement by the Federal Open Market Committee of its anticipation of an increase in the target range for the federal funds rate and the subsequent increase in such target range in December 2015. The staff observed that disclosure for a number of fixed income Funds warned investors (i) of the possible decline in the value of fixed income investments in response to an increased interest rate, (ii) that the potential risk in interest rates could result in periods of volatility and increased redemptions and (iii) that longer-term securities might be more sensitive to interest rate changes.

The second example relates to Funds' investments in debt securities issues by the Commonwealth of Puerto Rico and its agencies and instrumentalities ("**Puerto Rico**"). According to the staff, there have recently been concerns over whether Puerto Rico would default on its debt. The staff noted that certain Funds have names that signal that they invest in securities exempt from both federal income tax and the tax of a particular state, and because Puerto Rico debt is exempt from taxation from all states, according to the staff, some "single state" Funds may have notable exposure to Puerto Rico debt. The staff believes that disclosure in such single state Funds' prospectuses that such Funds invest in Puerto Rico debt helps communicate to investors that investors in such Funds are therefore indirectly exposed to the risk of Puerto Rico's defaulting on its debt.

- See a copy of the IM Guidance Update

Interagency Volcker Rule Guidance on Capital Treatment of Banking Entity Investments in TruPS CDOs

On March 4, 2016, the Federal Reserve and other Volcker Rule agencies, including the SEC (together the "**Agencies**"), added a new question and answer to their frequently asked questions ("**FAQs**") regarding section 13 of the Bank Holding Company Act of 1956 (the "**BHCA**") and the implementing regulations (the "**Final Rule**") promulgated thereunder (together, commonly known as the "**Volcker Rule**"). The new FAQ #21 addresses the capital treatment of banking entity investments in collateralized debt obligations backed by trust preferred securities ("**TruPS CDOs**") and clarifies that a banking entity is not required to deduct from its tier 1 capital an investment in a TruPS CDO retained pursuant to the interim final rule on TruPS CDOs approved by the Agencies in January 2014.[1] For a detailed discussion of previously issued FAQs, please see the June 18, 2014 Davis Polk Client Memorandum, **Volcker Rule: Observations on Interagency FAQs, OCC Interim Examination Guidelines**, the **March 26, 2015 Investment Management Regulatory Update** and the **August 25, 2015 Investment Management Regulatory Update**.

The Volcker Rule generally prohibits a banking entity from acquiring or retaining an ownership interest in, sponsoring or entering into certain relationships with a "covered fund" (which includes hedge funds, private equity funds and other private funds), subject to a number of exemptions. The interim final rule added Section __.16(a) to the Final Rule, which permits a banking entity to retain an interest in, or act as sponsor (including as trustee) of, an issuer of TruPS CDOs so long as (i) the issuer was established, and the interest was issued, before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the issuer were invested primarily in "Qualifying TruPS Collateral"[2]; and (iii) the banking entity's interest in the vehicle was acquired on or before December 10, 2013 (or was acquired in connection with a merger or acquisition) (a "**Qualifying TruPS CDO**").

Section __.12 of the Final Rule permits a banking entity to acquire and retain investments in a covered fund that the banking entity organizes and offers under Section __.11, subject to certain restrictions, for purposes of (i) establishing the fund and providing it with sufficient initial equity for investment to allow the fund to attract unaffiliated investors (i.e., seeding the fund); and (ii) making a *de minimis* investment. The Volcker Rule in Section __.12 also requires a banking entity to deduct from tier 1 capital the full amount of its investment in such a covered fund for purposes of calculating compliance with applicable regulatory capital requirements.

FAQ #21 states that such requirements in Section __.12 of the Final Rule, including the capital deduction, do not apply to Qualifying TruPS CDOs held in accordance with the interim final rule because Section __.16(a) provides an additional and independent exemption for Qualifying TruPS CDOs. The Agencies explain in FAQ #21, however, that if a banking entity acts as a market maker with respect to interests in a Qualifying TruPS CDO that is a covered fund, then the capital deduction provision in Section __.12 would apply to those interests. Finally, FAQ #21 clarifies that if a banking entity relies on Section __.12 to hold an interest in a TruPS CDO that is a covered fund but is *not* a Qualifying TruPS CDO, the banking entity

[1] *See* Davis Polk Capital and Prudential Standards Blog, *Volcker TruPS CDO Interim Final Rule: The Bottom Line* (posted Jan. 15, 2014), *available at* **http://blog.usbasel3.com/volcker-trups-cdo-interim-final-rule-the-bottom-line/**.

[2] Qualifying TruPS Collateral is defined in the interim final rule to mean any trust preferred security or subordinated debt instrument issued prior to May 19, 2010 by a depository institution holding company that, for any reporting period within the 12 months immediately preceding the issuance of such instrument, had total consolidated assets of less than $15 billion or issued prior to May 19, 2010 by a mutual holding company.

would be required to comply with all the limitations and restrictions in Section __.12, including the requirement to deduct its investment from tier 1 capital.

- **See a copy of the FAQ**

SEC Director Grim Addresses PLI Investment Management Institute

On March 3, 2016, David Grim, Director of the Division of Investment Management of the SEC (the "**Division**"), delivered remarks to the PLI Investment Management Institute. Grim discussed the key issues facing the investment management industry and the Division that were highlighted during SEC's celebration of the 75th anniversary of the Investment Company Act of 1940 and the Investment Advisers Act of 1940 (together, the "**Acts**"). Grim credited the SEC's continued ability to protect investors to the adaptability of the Acts, even as the market and asset management industry evolved over last 75 years. He noted that the Acts' adaptability will be vital in addressing the issues presented by: (i) the rapid development of exchange-traded funds ("**ETFs**"), (ii) investment company disclosure and reporting initiatives, (iii) the activities of private fund advisers and (iv) the role of boards in investment company oversight.

Grim cited the genesis and rapid growth of ETFs as signals of the Acts' continued flexibility to adapt to innovative financial products, especially as more recent ETFs have been focused on niche markets or actively-traded strategies. He explained that the SEC's ability to act through exemptive orders has enabled the operation of ETFs as their market has developed. To aid the SEC's continued response to the rapid development of new ETF products, Grim noted that the SEC had proposed a request for comment focused on ETFs in June 2015 and was continuing to review the responses. Grim also addressed the SEC's various rulemaking initiatives, including the May 2015 Reporting Modernization proposal, which included a provision to collect more data tailored to ETFs. For further discussion on these proposed rules, please see the June 18, 2015 Davis Polk Client Memorandum, **SEC Proposes Rules to Modernize and Enhance Information Reported by Investment Companies and Investment Advisers**. For more information about the proposed rule regarding liquidity risk management, please see the **October 27, 2015 Investment Management Regulatory Update**. In addition, according to Grim, the recently proposed rules regarding derivative limits discussed the effect on alternative-strategy ETFs and asked for comment on whether different limits should be set for certain ETF types. For further discussion on these proposed rules, please see the December 29, 2015 Davis Polk Client Memorandum, **SEC Proposes New Limits on Registered Funds' Derivatives Use**.

Grim continued by discussing the importance of disclosure and reporting in the functioning of the Acts and the SEC's recent enhancements to the reporting regime. According to Grim, the Division currently employs 65 people to review the filings of more than 12,000 registered investment companies each year. Grim noted that Form ADV, and Form PF through the SEC's publication of anonymized and aggregated Form PF data, have each expanded the information available to investors, and a current proposal would enhance information gathering about separately managed accounts. According to Grim, the SEC has acted to keep its forms, filing procedures and information availability current with the changes in the industry and has acted to improve the content of the disclosures, in ways such as guidance on summary prospectus drafting and on choosing a fund name. Grim also noted that the newly proposed reporting forms, N-PORT and N-CEN, will enhance the SEC's understanding of the products available in the industry and help investors supplement the existing disclosures.

Grim further addressed the Dodd-Frank Wall Street Reform and Consumer Protection Act's (the "**Dodd-Frank Act**") expansion of the SEC's information on private fund advisers. According to Grim, the Dodd-Frank Act required many private fund advisers to register and file a Form ADV for the first time, expanded the SEC's knowledge of the private fund industry and subjected certain private fund advisers to the entirety of the Advisers Act's rules. The Division's private fund branch has provided guidance on the rules' application to private fund advisers. Grim further credited Form PF with providing significant new data to the SEC, especially regarding the use of leverage, exposure to counterparty risk and individual trading practices. He also explained that the SEC uses the information gathered from Form PF in connection with pre-examination evaluations to prepare for investigations and to monitor investment strategies. Grim further noted that the SEC has now published four quarters of aggregated, anonymized data to provide enhanced information about the industry to investors and to other advisers.

Finally, Grim addressed the role of registered investment company boards in oversight. Oversight, he noted, is distinct from daily management in that it is primarily concerned with overseeing the various parties that provide essential services to the registered investment company. He emphasized that the Division's recommendations and guidance are aimed at providing directors with the tools they need to perform their oversight function. He further cited the recent SEC staff guidance on distribution and sub-accounting fees and the staff guidance on cybersecurity as examples of such efforts. For more information on the SEC staff's guidance about sub-accounting fees, please see the **January 27, 2016 Investment Management Regulatory Update**. For more information on the SEC staff's guidance about cybersecurity, please see the **May 20, 2015 Investment Management Regulatory Update**. Grim also noted that the SEC's recently proposed rule regarding liquidity risk management for open-end investment companies would require each registered investment company's board to approve a liquidity risk management program, review an annual report from the adviser about its adequacy and designate the adviser or officers responsible for its daily administration. According to Grim, the recent proposal regarding derivatives would also elevate the responsibility of registered investment company boards in monitoring derivative use.

Grim closed by stressing the importance of receiving input from industry stakeholders on the SEC's rulemaking initiatives.

- **See a copy of the Speech**

SEC Chair White Addresses "SEC Speaks" Program

On February 19, 2016, SEC Chair Mary Jo White delivered remarks to the 45th annual "SEC Speaks" program. White highlighted the SEC's accomplishments in 2015, previewed the agency's agenda for 2016 and discussed the SEC's need to "go beyond" disclosure to address the increasing complexity of markets and the attendant risks.

White began by remarking on the SEC's efforts to carry forward its mission to protect investors, first through the unprecedented number of enforcement actions brought by the Division of Enforcement in 2015, as well as through the large number of exams conducted by the National Exam Program last year. White remarked that the SEC's enhanced technology and new initiatives, such as self-reporting, helped the SEC target the most significant risks for investors, including cybersecurity, market structure requirements, dark pools, microcap fraud, financial reporting failures, insider trading, disclosure deficiencies in municipal securities offerings and protection of retail investors and retiree savings. In addition, White noted that the efforts of the divisions of Corporation Finance, Trading and Markets and Investment Management in reviewing thousands of registrant filings in 2015, as well as the numerous papers and analyses released by the Division of Economic and Risk Analysis, similarly furthered the SEC's mission to protect investors. Finally, White highlighted the SEC's various interactions with registrants and investors over the past year though the Office of Investor Education and Advocacy's in-person events and handling of direct investor questions and complaints.

White next discussed the SEC's rulemaking accomplishments in 2015. First, White noted that the SEC's adoption of Regulation A+ and Regulation Crowdfunding marked the completion of all major rulemakings directed by the JOBS Act and that the agency has entered the final phase of implementing the Dodd-Frank Act through its focus on the two remaining mandates – regulation for security-based swaps and executive compensation. According to White, the SEC adopted rules for (i) reporting and disseminating security-based swap information, (ii) registering security-based swap dealers and (iii) ensuring that non-U.S. dealers participating in the U.S. market abide by the SEC's rules, and the SEC also proposed a process to address bad actors in the security-based swap market. Regarding executive compensation regulation, White highlighted the SEC's proposals regarding (i) disclosure of whether a company permits its executives to hedge the company's stock, (ii) disclosure of pay versus performance measures of executive compensation and (iii) new disclosure and rules for clawing back erroneously awarded incentive compensation. Finally, White noted that the SEC adopted the final pay ratio rule in August 2015.

Next, White turned to the SEC's plans for 2016, highlighting the SEC's priorities to finalize the remaining security-based swap rules and the substantive requirements for security-based swap dealers, with a particular focus on rules governing their business conduct and requirements for their capital, margin and asset segregation.

In addition, White noted the SEC's discretionary rulemaking efforts in three areas, which the SEC acted on in 2015 and planned to continue to focus on this year: the asset management industry, the structure of the equity markets and the SEC's disclosure regime. First, White highlighted the SEC's adoption of final rules reforming the money market fund industry and the SEC's proposal for rules requiring enhanced reporting for investment advisers and mutual funds. For a detailed discussion of the amendments to the rules and related requirements governing money market funds, please see the August 5, 2014 Davis Polk Client Memorandum, **SEC Adopts Money Market Fund Reforms**. Further, White noted the SEC's proposed reforms to promote stronger liquidity risk management across open-end funds and the agency's approval of a proposal to require that funds monitor and manage derivatives-related risks and set limits on their use. For further discussion of the liquidity risk and derivative use proposals, please see the **October 27, 2015** and **December 21, 2015 Davis Polk Investment Management Regulatory Updates**. White noted that finalizing these rules and preparing proposals for transition planning and stress testing are the SEC's 2016 priorities for the asset management industry. Second, White addressed the SEC's efforts to change the structure of the equities market through proposals to broaden the oversight of active proprietary traders and to update the regulations for alternative trading systems. According to White, the SEC seeks to finalize these rules in 2016 and advance rules requiring enhancements to order routing disclosures and the risk controls on trading algorithms. In addition, White highlighted the agency's notice of proposed rulemaking on transfer agents, which would be the first major action in the area in more than 40 years, as well as the efforts of the Self-Regulatory Organizations ("**SROs**") to evaluate the operation of the limit up-limit down plan under various market conditions and their plan for a consolidated audit trail. For further discussion of proposed transfer agent rules, please see the **January 27, 2016 Davis Polk Investment Management Regulatory Update**. Third, White discussed the SEC's continuing efforts to review disclosure effectiveness, including the SEC's publication of its request for comment regarding the form and content of financial statement disclosures by entities other than the registrant under Regulation S-X. White noted that the SEC would likely follow up with similar requests for comment addressing Regulation S-K and the industry guides. Finally, White noted additional priorities in 2016, including shortening the settlement cycle from T+3 to T+2, enhancing filings through expanded use of structured data, finalizing rules updating the intrastate offering exemption and resource extraction and considering recommendations for a universal proxy. White closed by noting the Division of Enforcement's continued focus on financial reporting, market structure and the structuring, disclosure and sales of complex financial instruments, the continuing work to develop a uniform fiduciary duty for investment advisers and broker-dealers and the SEC's focus on creating a workable program for third-party reviews to enhance the compliance of registered investment advisers.

Finally, White not only commented on the SEC's role as a "disclosure agency," she also noted the SEC's responsibility to set financial standards for broker-dealers, review filings by exchanges and SROs, supervise securities clearing and oversee the Public Company Accounting Oversight Board, and how such responsibilities have become increasingly important as marketplaces have grown more complex. According to White, the SEC's recent regulatory reforms, such as Regulation SCI, Regulation A+ and the new money market fund reforms, highlight this progression, and the SEC intends to continue to look beyond disclosure in certain of its outstanding proposals and initiatives, including imposing liquidity requirements and limits on derivatives in the asset management space. White emphasized that the SEC's increasing focus beyond disclosure did not indicate a shift from its core disclosure powers, and according to White, disclosure enhancements continue to be a key aspect of all new rulemakings.

- **See a copy of the Speech**

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